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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 348

BENEFICIAL FINANCE COMPANY, INC.,

Petitioner,

v.

LEO VINE,

Respondent.

BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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The petition for a writ of certiorari to review a judgment of the United States Court of Appeals for the Second Circuit should be denied.

Question Presented

For purposes of the Federal securities laws, is a public stockholder a "seller" of securities when he is forced to surrender his shares in a going business for cash, as a result of a short-form merger?

Statement

Crown Finance Company ("Crown") was a small publicly owned finance company, whose stock was traded in the over-the-counter market when plaintiff

(Respondent) Vine bought 100 shares of its Class A Common Stock in 1962. Unknown to Vine, Crown had been a subsidiary of Beneficial Finance Company, Inc. ("Beneficial") until 1950, and had shared an interlocking directorate with Beneficial for many years. After 1950, the former employees of Beneficial, who constituted Crown's key officers and directors, maintained their close working relationship with their former employers at Beneficial. In 1963, Beneficial and the directors of Crown formulated a plan whereby Beneficial would reacquire Crown from these friendly "insiders" and the public owners of Crown's stock.

This plan is the subject matter of Vine's complaint. Vine alleges that the plan was a scheme to defraud the public stockholders of Crown by reacquiring the corporation at less than its full value and allocating the consideration required so as to grossly overpay the "insiders" for their securities and grossly underpay the public for its securities.

The steps in the plan were (1) a non-arms length buy-out of control stock, made possible through Beneficial's control over Crown's officers and directors, (2) a series of misleading tender offers to the public which achieved a buy-out of 95% of the outstanding stock of Crown, and (3) a short form merger under state law resulting in an involuntary sale to Beneficial's New York subsidiary of the remaining shares in the hands of the public, whose numbers were sufficiently reduced through the effects of steps (1) and (2) to permit this final "freeze out" of the public shareholders. In the short form merger, the surviving corporation, Beneficial, was able to require remaining

minority shareholders in Crown to take cash in exchange for their securities, and retain the assets and business of Crown for itself. Vine contends that this was a "forced sale" of his securities in Crown.

Plaintiff's case is that the whole series of events were motivated and tainted by a scheme to defraud and that the key step (2) involved a series of tender offers which clearly violated the securities laws. At the end of the game, Beneficial had the going business and properties of Crown at an unconscionably low price, and plaintiff had merely the right to a cash sum of $3.29 per share for his stock. All these carefully planned moves by Beneficial were essential steps in the execution of the scheme and not just unrelated events. Each step in the scheme was aimed at buying out or cancelling out securities held by the public. and plaintiff therefore complains that he was a forced seller of his stock in Crown, under a scheme to defraud in connection with such sale.

The details of the scheme are as follows: For some time prior to the merger there were two classes of Crown stock outstanding: 624,870 shares of Class A stock and only 46,500 shares of Class B stock. Over 97% of the shares of Class B stock were in the hands of the officers and directors of Crown; the Class A stock was in the hands of the public. The B stock, as a class, had the right to elect two-thirds of Crown's Board of Directors, but each share of the publicly held Class A stock had the right on liquidation to ten times the sum paid to each share of Class B stock. On all matters, such as mergers and liquidations, each share of the two classes of stock voted share for share alike.

The overt acts in Beneficial's scheme commenced in 1963. First, Beneficial negotiated with Crown's officers to re-acquire Crown, its former subsidiary, in its entirety as a going concern. The task was greatly facilitated since Crown's insiders were former Beneficial employees, the two companies had had interlocking directorates, and among other things, age motivated Crown's officers toward the security which Beneficial offered in a merger.[1] Arm's-length bargaining did not take place. As a result of these negotiations, Beneficial purchased the controlling Class B stock of Crown from its officers and directors, at $15.00 per share, for almost $700,000 in excess of its book value. These insiders were also given some $200,000 in benefits under employment and consulting agreements. Consequently they received some $900,000 at the time the book value of their Class B stock was approximately $12,500 or $.27 per share. Respondent's Appendix pp. 33, 35-37, 39.[2]

Secondly, several tender offers were made by Beneficial to the public holders of the Class A stock. The first tender offer was made in the same month that Beneficial purchased the Class B shares. When in-

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[1] These facts which laid the groundwork for the fraud in merging Crown with Beneficial were discovered after the action was filed. They were before the Circuit Court in the allegations of the proposed Second Amended Complaint, and are summarized in the opinion below by the references to Crown being a defacto subsidiary of Beneficial instead of an independent company. (A.17) These key facts will, of course, be part of ultimate proof in the case under the allegations of non-arms-length bargaining contained in that portion of the Amended Complaint upheld by the Court below.

[2] References herein to Respondent's Appendix are indicated by "Respondent's Appendix —". References to Petitioner's Appendix are indicated by "A. —".

sufficient shares were tendered at $1.25 per share, the offer was raised to $2.50 per share. In making its tenders, Beneficial failed to inform Crown's public stockholders of Beneficial's relationship and prior arrangements made with Crown's insiders, the true book value of the public's shares, the value of their shares on liquidation, the worth of the business, and other material facts. Respondent's Appendix pp. 37-38.

Even the District Court, which first dismissed Vine's complaint conceded that the misleading tender offer gave rise to a securities fraud cause of action in favor of the Crown stockholders who accepted the offer. The amicus curiae brief of the Securities and Exchange Commission characterized the tender offer as "a clear violation of Rule 10b-5." (Respondent's Appendix pp. 45, 36)

By 1965, Beneficial had purchased 95% of all the Crown stock. No vote of shareholders now being necessary under state law, Beneficial completed the third stage, the short form merger of Crown into Beneficial. Beneficial now offered to pay the remaining minority Crown Class A stockholders $3.29 per share, while it succeeded to the properties and business of Crown through the merger into Beneficial's New York subsidiary. Respondent's Appendix pp. 40-41.

As a result of the scheme, Class A stockholders received only $800,000 for their stock, $870,000 less than they would have received if they were paid merely the book value of their shares, $1,670,000. Class B insiders received the disproportionate benefits already described. Beneficial, by gaining the aid of the Class B insiders, and by underpaying the Class A public

stockholders purchased at least $300,000 in tangible assets and $500,000 in going concern value, i.e. a windfall of $800,000 in values without paying for them. Respondent's Appendix p. 39.

Beneficial could not have accomplished this result if Crown's "insiders" had not been willing pawns, and Beneficial had forthrightly offered to purchase all of Crown's stock or had permitted Crown's public stockholders to vote upon the overall plan of merger. Vine refused to surrender his share certificate when the merger went through, and his stock has become a claim for cash, $3.29 per share, i.e. a kind of note owed by Beneficial's New York subsidiary which survived the merger.

The action was brought by Vine both derivatively and on behalf of all the Class A stockholders on the ground that Beneficial had defrauded Crown and its Class A stockholders in violation of Rule 10b-5, 17 C.F.R. 240.10b-5 promulgated under Section 10b of the Securities Exchange Act of 1934 ("the Act" or "the 1934 Act"), 15 U.S.C. 78(j)(b). A common law clause of action was also alleged.

The District Court granted a motion to dismiss the complaint on the ground that Vine was not a "seller" of securities and therefore had no standing to bring an action based on a violation of Rule 10b-5. The Court of Appeals reversed the District Court insofar as it had dismissed the representative action and held the complaint stated a cause of action under Rule 10b-5. The petition is addressed to this aspect of the unanimous decision below.*

* Certain other procedural steps are not relevant here.

As did the District Court, the Court of Appeals concentrated on the technical question of interpreting "seller" and "purchaser" as those terms are defined in the Act. The Court of Appeals had the aid of a brief filed amicus curiae by the Securities and Exchange Commission at the invitation of the Court, agreeing in substance with Vine's position that he was a forced seller of securities in the short-form merger, and Beneficial was a purchaser of those securities in the transaction. (Respondent's Appendix 20-25)

The Petition Should Not Be Granted because the Decision Below Merely Applies Existing Principles as to the Nature of a "Seller" of Securities Under the Securities Acts.

I

The decision below was a narrow holding to the effect that the exchange of stock for cash as a result of a merger is a "sale" of securities, if a scheme to defraud underlies the transaction. The starting point of the decision was the wise principle that the securities statutes are not aimed at corporate mismanagement in general, but only at wrongdoing involving transactions in securities. In recognizing the validity of Vine's position the Second Circuit was mindful that the Securities Exchange Act of 1934 was one of

> "a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. . . . A fundamental purpose common to

> these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry. As we recently said in a related context, 'It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry. *Silver* v. *American Stock Exchange*. . . ." *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-7 (1963).

In the case at bar, the Second Circuit's carefully phrased decision is expressly limited to the technical points covered by the decision of the District Court dismissing the Amended Complaint.

> "Its basic holding was narrow; the federal action failed [in the view of the District Court] because Vine was not a 'seller' of securities." (A. 2)

In reversing the order of dismissal the Court of Appeals' decision was grounded upon the definitions of "seller" and "purchaser" as they appear in the Act. The Second Circuit expressly limited its holding that Vine must be considered a seller by stating that:

> "Under the particular circumstances of this case, we hold that appellant is a seller under the Act." (A. 12)

On this basis the Court of Appeals went on to rule that Vine could maintain a class action on behalf of the Class A stockholders. It noted that Vine still held his Class A stock but rejected defendant's contention

that this precluded him from being considered a "seller" of securities under the Act. Without mentioning Vine's obvious reason for not turning in his certificate, i.e., his desire to preserve his technical standing as a stockholder bringing a derivative action, the Court of Appeals said:

> "Since, in order to realize any value for his stock, appellant must exchange the shares for money from appellee, as a practical matter appellant must eventually become a party to a 'sale', as that term has always been used. . . . It is true that appellant still has his stock; if he turned it in . . ., it would be clearer that appellant is a seller. Assuming that this would not otherwise affect his right to sue under the Act and the Rule, requiring him to do so as a condition to suit seems a needless formality.
>
> "We do not construe the Act so narrowly." (A. 10-11)

Thus, as in *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), a party, not personally "defrauded" in a formalistic sense was permitted to represent his class—in the instant case as a forced seller. When the short-form merger occurred, Vine's equity interest in a going business became a piece of paper entitling him to cash, $3.29 per share. The fraud practiced upon him cancelled his equity and forced him to surrender his certificate for cash. The last link in the three stage plan was the short-form merger. The scheme of fraud worked on all the remaining public stockholders of Crown, and the Second Circuit said that Vine could bring this action on behalf of all

the public stockholders caught up in the same scheme. As this Court has said previously:

> "The damage suffered results not from the deceit practiced on him [the small stockholder] alone but rather from the deceit practiced on the stockholders as a group. Private enforcement of the . . . rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements." *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 432 (1964)

II

The decision below is in accord with those of other courts including those of this Court. *SEC* v. *Capital Gains Research Bureau, Inc., supra; J. I. Case Co.* v. *Borak, supra.*

Two cases, strikingly parallel to the case at bar, have been decided similarly in the last few years. In *Voege* v. *American Sumatra Tobacco Corp.,* 241 F. Supp. 369 (D. Del. 1965), the Court sitting in the state of Crown's incorporation, ruled on a motion to dismiss the complaint, that derivative and representative actions would lie where, the controlling interests of "Old Company" had perpetrated a scheme almost identical to the one at bar. In *Voege* the controlling group made a tender offer, obtained sufficient shares to effect a short-form merger under Delaware law, merged "Old Company" into "New Company" and

forced the minority stockholders to take dollars for their shares. The plaintiff alleged fraud in violation of Rule 10b-5 in the tender offer as part of the entire scheme to force minority stockholders to take cash for their stock. The only response petitioner could make to this precedent on all fours with the instant case was to argue that it was wrong, and "flies in the face of the Act." Where the Courts below in the case at bar were both satisfied to rest their decisions upon interpretation of the Act, in *Voege* the Court sitting in Delaware, theorized that under Delaware law the certificate of incorporation was indeed a contract pursuant to which

> ". . . in net effect when plaintiff bought her shares, she agreed that in the event of a merger the corporation surviving the merger should have an option to buy her shares at a price to be determined in the future.
>
> "The frauds allegedly perpetrated upon plaintiff were, in a very real sense, related to a vital part of the contract (the fixation of the purchase price) under which plaintiff had agreed to sell. They were committed "in connection with the purchase [and] sale" of a security within the meaning of Rule 10b-5. Any other view would defeat the purpose of Rule 10b-5 . . . *Voege* v. *American Sumatra Tobacco Corp., supra* at 374.

And in *Dasho* v. *Susquehanna Corp.*, 380 F. 2d 262 (7th Cir., 1967) pet. for cert. filed sub nom *Bard* v. *Dasho,* Sept. 25, 1967, the Court had before it a derivative action where minority stockholders of a corporation merged into another company were being forced by the merger to take new company shares for

their old company shares. The only difference between *Dasho* and the instant case is that shares were exchanged for shares therein, and shares were exchanged for cash in the instant case. In *Dasho* the Court held that a public stockholder caught up in the merger was a "seller" of securities for purposes of Rule 10b-5, noting

> "Our attention is called to Sections 3(a) (13) and 3(a)(14) of the Exchange Act, . . . which define the word 'purchase' to 'include any contract to buy, purchase, or otherwise acquire', and 'sale' to 'include any contract to sell or otherwise dispose of'. This broad language indicates an intention by Congress that the words 'purchase' and 'sale' are not limited to transactions ordinarily governed by the commercial law of sales. The purpose is evidently to make control of securities transactions reasonably complete and effective to accomplish the purpose of the legislation." *Dasho* v. *Susquehanna Corp.*, 380 F.2d at 266.

The Court in *Dasho* relied in part upon *SEC* v. *W. J. Howey Co.*, 328 U.S. 293 (1946) which defined the term "investment contract" in the Securities Act of 1933 ("the 1933 Act"). The *Dasho* court recognized that the securities laws required:

> ". . . a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 380 F.2d at 267 (quoting *SEC* v. *W. J. Howey Co., supra* at 299)

In this context the *Dasho* court met the merger-sale problem head-on. It reasoned that in the federal securities law area the words "seller" and "purchaser" were never intended to be limited to the conceptional framework surrounding them at common law. In *Wilko* v. *Swan*, 346 U.S. 427 (1953), this court refused to so limit those words as they appear in the 1933 Act. The 1934 Act was intended to extend the zone for the protection of investors initiated by the 1933 Act. The *Dasho* court held therefore that the language in the 1934 Act parallel to that used in the 1933 Act cannot be deemed to revert to the abandoned limiting concepts of the common law. It noted that investors, enmeshed in the complex mechanics of a merger with its opportunities for fraud, needed the protection of the Act as much as investors selling for cash in an open market transaction.

In the instant short-form merger case, there is an additional element of compulsion lacking in ordinary mergers. The public stockholders are being forced out of the business by being given cash instead of securities in the continuing enterprise. Deception of the public at an earlier stage in the scheme put the last few stockholders in a position where they had to sell their securities.

The thinking of the Second Circuit in the case at bar and of the Seventh Circuit in *Dasho* are simply applications of existing federal securities law. Forced sellers in similar situations have long been able to obtain redress for their grievances under the anti-fraud provisions of the 1933 Act and the 1934 Act. Plaintiffs were able to maintain their actions under the anti-fraud provisions of the securities laws in *Speed* v.

Transamerica Corp., 235 F.2d 369 (3rd Cir., 1956) and *Zahn* v. *Transamerica Corp.*, 162 F.2d 36 (3rd Cir., 1947) where they were being forced to turn in their preferred stock in an involuntary redemption of those shares. The Third Circuit is where Rule 10b-5 civil liability originated, and the Delaware District Court sitting in *Voege* v. *American Sumatra Tobacco Corp., supra*, was continuing its tradition of applying the broad definitions of the Act to all forms of deceptive practices in securities.

In *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir., 1960) the Fifth Circuit held that a corporation's issuance of stock in return for assets constituted a sale of securities for purposes of Rule 10b-5. In *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2d Cir., 1964), the Second Circuit held there was a sale of securities where the corporation was in the process of being misled by some of its own directors into issuing its treasury stock; the stock had not yet been "sold" when injunctive relief was granted under Rule 10b-5. In *Blau* v. *Hodgkinson*, 100 F.Supp. 361 (S.D.N.Y., 1951) the District Court decided that an exchange of stock in a subsidiary for that of a parent in a corporate reorganization was a contract to "sell" securities.

The strongest precedent petitioner could muster in support of its position is an outworn theory that "volition" is required for a sale of securities, contained in an amicus brief filed by the S.E.C. twenty-five years ago in the Ninth Circuit. In the instant case, the S.E.C. strongly urged that the short form merger herein resulted in a purchase and sale of Vine's stock within the meaning of Rule 10b-5. The

compulsion implicit in mergers is one of the strongest reasons for making securities transactions therein subject to the fraud statutes. What the petitioner is trying to do is to persuade this Court to overturn the law in this area exemplified by the decisions of the Second, Third, Fifth and Seventh Circuits. There is complete harmony among all of the Circuit Courts which have considered the issues of law herein. The technical area narrowly explored in *Vine* hardly makes it an appropriate vehicle for attenuating well established principles in this field.

III

The Second Circuit has already recognized that, in the case at bar, it has merely added a slight precedent in its attempt to define the area in which Rule 10b-5 is properly operative.

> "... various concepts have been utilized to limit liability under the sweeping language of the Rule, although none is specifically required by it.[1] Thus a requirement of privity was at first suggested[1] but has more recently been ignored.[1] However the search for limiting doctrine has continued.[1] Thus, some courts have looked to see whether a plaintiff actually relied on the allegedly fraudulent statement,[1] whether such reliance was reasonable,[1] whether the fraud actually caused harm to plaintiff,[1] whether the plaintiff's injury was foreseeable,[1 2] and whether plaintiff falls within the category of a buyer or a seller of securities.[1 2]" *Mutual Shares Corp.* v. *Genesco*

[1] Citations and citation footnotes omitted.

[2] Citing *Vine*, the case at bar.

Inc.—F.2d.—(2d Cir., 1967), CCH Fed. Sec. Law Rep. par. 91,983 at p. 96,343

In citing *Vine* since it was decided, the tendency has been to limit the decision:

> ". . . the offer to stockholders [in *Vine*] was made by insiders; plaintiff Vine was a member of the class to whom the offer was specifically addressed; and the issue decided was whether Vine was an involuntary 'seller' because the corporation in which he owned stock had been dissolved, leaving him only with shares which had been converted into a claim for cash." *Mutual Shares Corp.* v. *Genesco, Inc., supra,* CCH Fed. Sec. Law Rep. par. 91,983 at p. 96,344.

A. T. Brod & Co. v. *Perlow,* 375 F.2d 393 (2d Cir., 1967); *Symington Wayne Corp.* v. *Dresser Industries, Inc.,* —F.2d— (2d Cir., 1967), CCH Fed. Sec. Law Rep. par. 91,978. Compare *Dasho* v. *Suquehanna Corp., supra.*

The Southern District of New York has similarly read the opinion in this limited way. *Pacific Insurance Co.* v. *Blot,* 267 F. Supp. 956 (S.D.N.Y., 1967).

IV

In *Vine* the Second Circuit did not go as far as was advocated by the Securities and Exchange Commission, an organization whose special province and expertise in this area has long been recognized by this Court. *SEC* v. *U. S. Realty & Imp. Co.,* 310 U.S. 434, 448-9 (1940). In its brief below, the Securities and Exchange Commission argued:

"The purpose of Section 10(b) of the Securities Exchange Act and of Rule 10b-5 is to protect security holders; appellant, as a stockholder of Crown, is entitled to the protections therein. The fact that damages are sought not by a selling stockholder but by another stockholder of the same company, claiming damages flowing from a loss of value in his stock by reason of the violation should be no ground for failure to apply the general rule that persons for whose benefit the statute was enacted may sue for damages caused them by its violation.[1]

"The Supreme Court has held that a stockholder may bring a cause of action based on comparable provisions of the Commission's proxy rules, even though the stockholder was not himself misled by the false statements in the proxy soliciting material that constituted the alleged violation." *Borak* v. *J. I: Case Co.* . . . In that case, as in this, the plaintiff alleged injury by reason of a merger brought about through use of misleading statements in violation of the Securities Exchange Act and the Commission's rules thereunder. The court made clear that if the plaintiff should be able to prove a 'causal relationship of the proxy material and the merger' . . . and that the merger resulted from fraud or was non-beneficial, plaintiff was entitled to relief. The Court also held that the right of action existed as to 'both derivative and direct causes'. . . . S.E.C. Brief, Respondent's Appendix 21-2.

Instead of following this "investor" theory, the Court of Appeals accepted, almost verbatim, the

[1] Footnote omitted.

S.E.C.'s interpretation of "sale" and "purchase" in sections 3(a) 13 and 3(a) 14 of the Act, 15 U.S.C. 78c(a)13, 78c(a)14. See also *Entel* v. *Allan*, 270 F. Supp. 60 (S.D.N.Y., 1967).

The Commission argued below (and presumably in its amicus brief in *Dasho*) that Congress made clear by its broad language in Sections 3(a)(13) and 3(a)-(14) of the Act, that it did not intend to limit the application of the 1934 Act to the concepts of sale ordinarily applicable in the commercial sphere. If it had so intended, it would not have defined purchase and sale to "include" contracts to buy and sell, and added "or otherwise" acquire or dispose of. As the S.E.C. said Congress intended to protect investors from the myriad possibilities of fraud and expected the law to do the job in a "reasonably complete and effective manner." Section 2, 1934 Act, 15 U.S.C. 78(b). The words "include" and "or otherwise" were placed in the statute to express its intended breadth; they cannot be read out of it. S.E.C. brief, Respondent's Appendix 22.

V

The decision below was correct in giving Vine the right, two years after filing his complaint, to go forward and prove his case. Section 10b and Rule 10b-5 are at the heart of the 1934 Act. The prohibition against the use of "any device, scheme, or artifice to defraud" or "the making of any untrue statement of a material fact" in any securities transaction is the very essence of the law, in that they are designed to cover plans as imaginative as that used by Beneficial

in the instant case—schemes that take several seemingly unrelated steps, schemes that euchre public stockholders out of the way so that other stockholders can be forced out. They are words whose interpretation is uniquely suited to the careful advance through the case by case method of the common law. This conservative tradition is the path the courts are following. *Mutual Shares Corp.* v. *Genesco, supra.* The Second Circuit has shown no enthusiasm for opening the gates in New York City to more securities fraud litigation than exists now by expanding the coverage of Rule 10b-5. The "parade of horrors" in Petitioner's brief are distortions of the problems of proof in a case such as this. Most of the evidence will be documentary, and the misleading representations were circulated on a uniform basis, in writing, to all stockholders. The deception of the public stockholders will be as self-evident as Beneficial's close relationship to Crown's "insiders" for some twenty years.

According to the complaint herein, defendants schemed and misled to defraud the very persons the Act is intended to protect, public stockholders. As a result of their machinations, Vine and those similarly situated were forced to give up what they had purchased—the right to risk their savings in a going concern. The Second Circuit below has simply ruled that if Vine can prove his allegations of fraud under Rule 10b-5, he and his class can recover. There is nothing startling about this concept, it is plainly based on the precedents of this Court and of the circuits. There is no real conflict in opinions and the decision is properly limited to the well-expounded facts in a narrow opinion rendered in the common law tradition. Certiorari is not appropriate.

CONCLUSION

The petition for a writ of certiorari should be denied since no ground of the character specified in Rule 19 of this Court applies.

Respectfully submitted,

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